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Understanding Options: Understanding Calls, Puts, and Why Options Exist

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Options are often associated with speculation, but they can also play an important role in risk management and portfolio construction. In the first part of our new series on Understanding Options, Grimes & Company Chief Investment Officer Matt Morse explains the foundational concepts behind options, including the difference between calls and puts, why options have value, and the role they can play in a thoughtful investment strategy.

Throughout this series, our investment team will build on these concepts to explore how options can be used to help manage risk, define potential outcomes, and support broader wealth management decisions. By starting with the fundamentals, you'll gain the context needed to better understand more advanced options strategies and how they may fit within a disciplined, long-term investment approach.

OTHER VIDEOS IN THIS SERIES:

- Understanding Options: The Hidden Risks of Covered Calls
- Understanding Options: Protective Puts and Collars
- Understanding Options: How We Think About Options

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VIDEO TRANSCRIPTION:

Over the next few videos, we're going to discuss options, not because we believe investors should speculate with them or because we think options are a shortcut to higher returns. In fact, our view is almost the opposite.

At Grimes, we think of options primarily as risk-management and portfolio-construction tools. They can help investors manage uncertainty, define outcomes, reduce risk, and in some cases support tax and diversification goals.

But before discussing specific strategies, we need to understand what options actually are, because many investors hear terms like covered calls, puts, collars, or protective hedges without fully understanding the building blocks underneath them.

So today, we're going to keep things simple: what is a call, what is a put, why do options have value, and what are investors really buying and selling when they trade them?

Let's start with a call option. A call option gives its owner the right, but not the obligation, to buy a stock at a specific price over a specific period of time.

There are two important terms. The first is the strike price, which is the agreed-upon purchase price. The second is the expiration date, which tells us how long the option remains valid.

Let's use a simple example. Suppose Apple stock is trading at $100 per share, and an investor purchases a call option with a strike price of $110 that expires in three months.

What did they actually buy? They purchased the right to buy Apple at $110, regardless of where the stock trades in the future.

If Apple rises to $130, that right becomes very valuable because they can buy shares at $110 even though everyone else is paying $130. But if Apple stays below $110, the option may expire worthless, and the investor simply chooses not to exercise it.

This is an important concept. A call buyer participates in upside without committing to buying the stock today. They are paying for potential future opportunity, and because of that opportunity, the option has value.

Now let's look at the other side: a put option. A put option gives its owner the right, but not the obligation, to sell a stock at a specific price over a specific period of time.

Again, let's use a simple example. Suppose an investor owns Apple stock at $100 and purchases a put option with a strike price of $90.

That option gives them the right to sell their shares for $90, even if the market price falls below that level. If Apple falls to $70, the investor still has the ability to sell at $90.

The put created a floor underneath the position, which is why puts are often compared to insurance.

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Think about homeowner's insurance. You hope you never need it, but you pay a premium because the protection may be valuable if something bad happens.

A protective put works similarly. The investor pays a premium in exchange for downside protection, and just like insurance, that protection costs money.

We'll come back to that idea later in this series because it becomes very important when discussing portfolio construction. For now, the key takeaway is simple: calls benefit from stocks going up, and puts benefit from stocks going down.

So if calls and puts are simply rights, what determines how much those rights are worth? Three factors matter most: strike price, time, and volatility.

First, strike price. The more favorable the strike price, the more valuable the option tends to be.

Second, time. More time means more opportunity for something to happen, so an option that expires in six months is generally worth more than one expiring next week.

And third, volatility. This is often the most misunderstood factor.

Stocks that move around a lot tend to have more expensive options because uncertainty creates opportunity. The greater the potential movement in the stock price, the more valuable the right to buy or sell at a predetermined level becomes.

In many ways, options are pricing uncertainty itself. That's why option markets become particularly interesting during periods of fear, excitement, earnings announcements, or major market events. The more uncertainty investors perceive, the more valuable option contracts tend to become.

The most important thing to remember is that options are not magic. They don't create returns from nowhere, and they don't eliminate risk; they simply redistribute risk.

One investor transfers risk to another investor. One investor buys protection while another sells it. One investor buys upside potential while another gives it away in exchange for cash today.

Understanding that tradeoff is the foundation for every options strategy.

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